

# **Fair Value or Unfair Value: Accounting for OTTI in a Distressed Economy**

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A Presentation to Federal Home Loan Bank of Seattle Members  
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## Look at the Headlines...

AIG Reports \$62 Billion Loss for Q4; \$99 Billion for Year

**U.S. Unemployment Climbs to 8.1%,  
Presaging Further Job Cuts, Foreclosures**

Citi's Stock Dips Below \$1, Down 85% This Year Alone

**Dow 5000? There's a Case for It**

Wells Fargo Says Accounting Change Increases Loss

**Federal Home Loan Banks Report Loss For 4Q**

# A Brief History of Fair Market Value Accounting

- **“Law of the Land” for most of the Great Depression**
- **Repealed in 1938**
- **FAS 115, which became effective in 1994, addressed Other Than Temporary Impairment (OTTI)**
- **FAS 157 fine tuned definition of “fair value” once OTTI is determined**

# Evolution of Other Than Temporary Impairment

- FAS 115
  - Set the Standard
- SAB 59
  - Length and degree to which fair value has been below amortized cost
- EITF 99-20 and SOP 03-3
  - Addressed broader accounting considerations specific to debt securities of lesser credit quality
    - Bonds purchased without expectation that all contractual cash flows will be received

# Other Than Temporary Impairment

## What does all of this mean?

A security is OTTI when it becomes probable that the investor will not get the cash flows they expected at purchase.

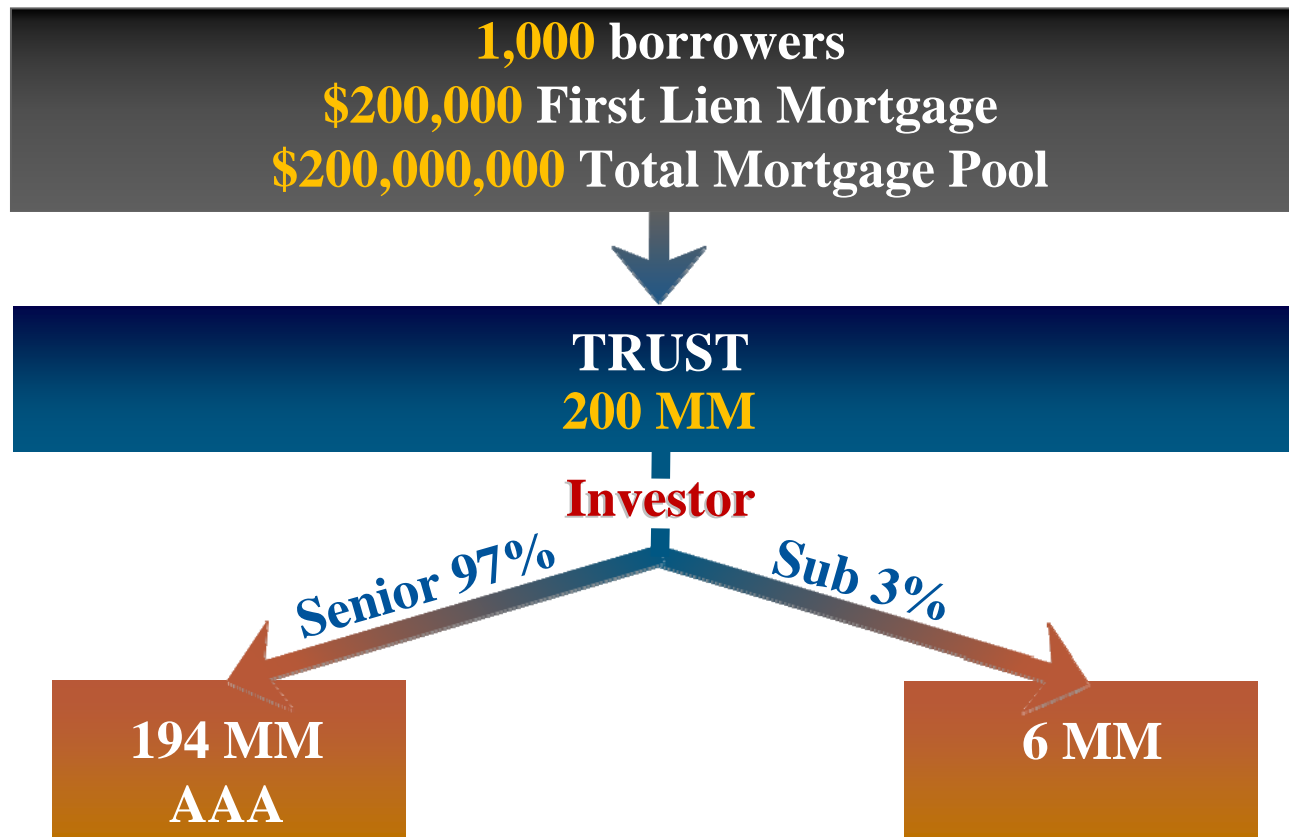
# Other Than Temporary Impairment

**“No bright lines.”**

# What are Potential Warning Signs?

1. Market value significantly below book
2. Ratings downgrade

# Simple Example - 2006



# Simple Example – 2009

## Assumptions:

- o Over the next 27 years, total of 8% will default
- o Each liquidated loan will lose 50% (severity)

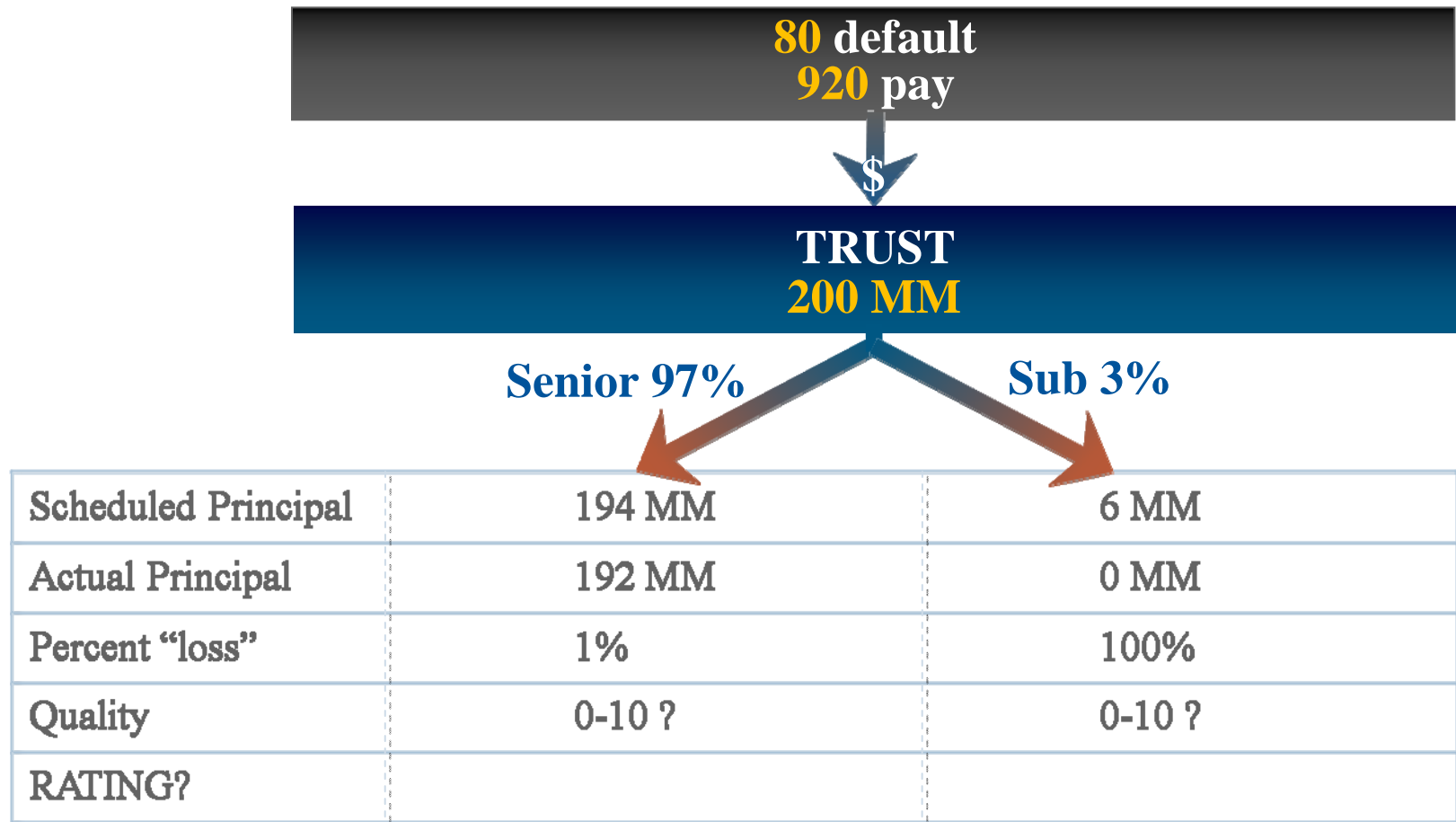
Total Pool Loss = defaults x severity

$$= 8\% \times 50\%$$

$$= 4\%$$

$$= \$8,000,000 \text{ Pool Loss}$$

# Simple Example – 2009 (continued)



# Ratings

AAA

- An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

AA

- An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

A

- An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

# Ratings

BBB

- An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

BB

- An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

B

- An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

# Ratings

CCC

- An obligation rated 'CCC' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

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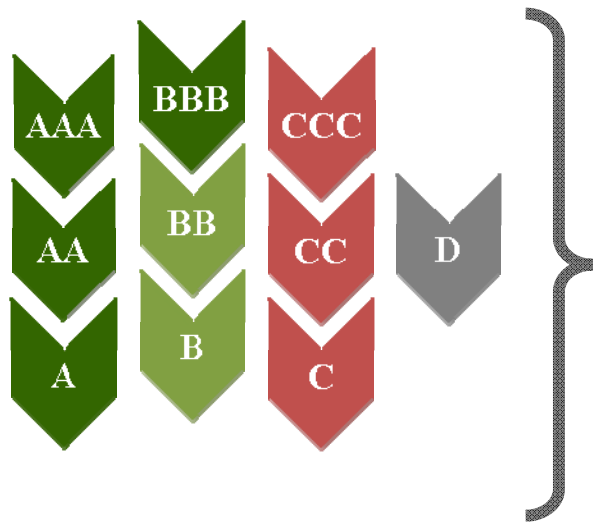
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• An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

CCC

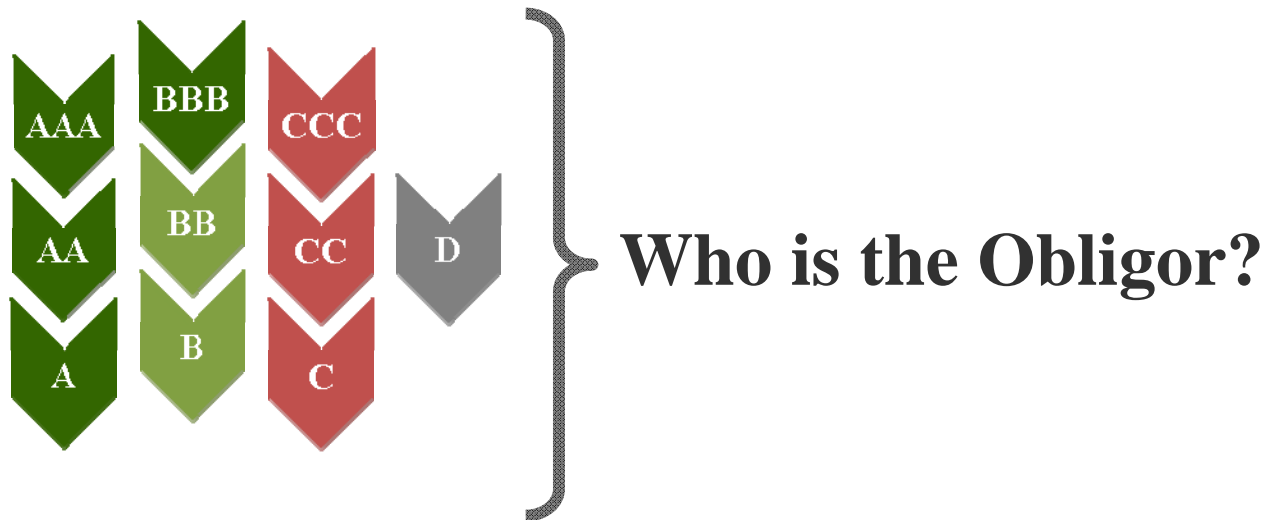
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# Ratings



**Which Ratings  
Suggest OTTI?**

# Ratings



If OTTI **NO** then Amortized Cost.

If OTTI **YES** then “Fair Value.”

**What is *Fair Value*?**

# How FMV Accounting Works in a “Normal” Economy

- Typically, FMV in a normally functioning market represents the intrinsic (economic) value of an asset. For example:
  - On a bond this is determined by present valuing the expected future cash flows
  - So  $FMV = Economic\ Value = PV\ of\ Future\ Cash\ Flows$

# Challenges of applying FMV in a “Distressed” Economy

- Does FMV apply when you don’t have a market?
- Paragraph 7 of SFAS 157 states:  
“A fair value measurement assumes that the asset or liability is exchanged in and *orderly transaction* between market participants . . . “  
  
“An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; *it is not a forced transaction* (for example, a forced liquidation or distress sale).”
- The FASB is working on clarifying this very issue with Proposed FASB Staff Position (FSP) FAS 157-e.

# Considering the Difference between Single and Multi-Obligor Securities?

- **Single Obligor**

- Rating is probability of default
- Rating makes no mention if expected loss of recovery
- Default 0% or 100%
- Severities typically large

**What is Fair Value for *Single Obligor Security*?**

# Consider the Difference between Single and Multi-Obligor Securities?

- **Multiple Obligor Security**

- Rating is probable return of principal
- Includes mention of expected loss recovery
- No “event of default”

**What is Fair Value for *Multiple Obligor Security*?**

# OTTI?

- Purchase estimate is critical
- An important distinction:
  - Expected contractual cash flows at purchase
  - Did not expect contractual cash flows at purchase
- A security is not automatically OTTI when contractual cash flows are no longer expected
  - Contractual cash flows = Face Value
  - Downgrades from rating agencies do not automatically mean OTTI
    - Credit ratings evaluate first dollar of loss from par
    - Loss estimate vs. purchase price discount
    - Expected yield “range”

# Be Prepared

- Pre-purchase analysis is critical
  - Document initial cash flow assumptions and yield estimates at purchase
    - Slow down recognition of accretion for bonds purchased at discount
      - Keep book price constant
      - Accrete to stated maturity
      - If possible, accrete to a book price less than par
      - GAAP allows alternative methods that are not materially different

# Be Prepared

- Pre-purchase analysis

- Range approach is acceptable

- SFAS 5 – Accrual For Loss Contingencies
      - When there is uncertainty as to the amount, a range is appropriate.
    - FASB Board member:

*There is a wide range of opinions on the cash flows of MBS in the market today and it's impossible to prove any number right. Investors must get the facts, analyze the data objectively, and stress test the possible scenarios.*

# Be Prepared

- **MUST** document intent and ability to hold until fair value recovers or cash is received (“maturity”)
  - o Intent
    - Minutes of ALCO or Board Meeting
    - State in Investment Policy
    - Budget
    - HTM vs. AFS vs. Trading
  - o Ability
    - Liquidity Policy
    - Adequate capital
    - Part of normal business practice

# Be Prepared

- Determine a method to assess OTTI and support it
  - Document general approach (policies and procedures)
    - Compare analysis performed today to analysis performed at purchase
  - Document specific analysis for all “cuspy” bonds and conclusions
    - Minutes of ALCO or Board Meeting
    - State specific bond approach in Investment Policy
    - Do this quarterly

# Be Prepared

- Determine a method to assess OTTI and support it
  - Create all documentation before auditors / regulators request it!
    - “Management’s assertion”
    - Easier to be proactive and defend your stance than to refute auditor position already established
      - Unprecedented market
      - Lack of consensus / consistency

# Recent Developments: FASB Proposal

- 3/16/09: Financial Accounting Standards Board (FASB) proposed two changes in guidance on OTTI:
  - Recognize entire impairment loss as OTTI if intent to sell, or "more likely than not" required to sell before recovering cost basis.
  - If no intent to sell, and not likely to be forced to sell before recovering cost basis, recognize only credit-loss portion as OTTI in earnings. The balance of the impairment loss would be charged to "other comprehensive income and would not affect Tier 1 Capital."
- Proposed result: OTTI that is unrelated to credit losses for held-to-maturity securities would be amortized over their remaining life and would not impact earnings.
- Proposal available on FASB Web site, with public comment accepted through April 1 for consideration at FASB board meeting on April 2.

# Potential Affects of FASB Proposal

- On PLMBS Investments
- On Investments in FHLBank Stock
- On Trust Preferred Investments and Other Investments

# Summary

- A security is OTTI when it becomes probable that the investor will not get the cash flows they expected at purchase.
- Purchase estimate is critical.
- We recommend a range method for OTTI. If current expectation falls below original lower band expectation, then the bond may be OTTI.
- OTTI evaluation is still complex and fraught with many assumptions (FASB Board member comment).
- Fair Value for multiple obligor securities vs. single obligor securities
- Industry is still wrestling with how to handle OTTI (“Mark-to-market Accounting”) and which is more important: full disclosure or preservation of capital.
- FASB proposal and possible affects.

# What Can You Do?

- Sample comment letter available at: [www.fhlbsea.com](http://www.fhlbsea.com)
- Send comments to: [director@fasb.org](mailto:director@fasb.org) by April 1.

# Questions?

# Thank you for attending!

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*Ask about our white paper for multi-obligor securities.*

