

# The Fair Value Option: How Attractive is It?



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# Agenda

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Key Guidance in FAS 159

Distinctions Between FAS 159 and 156

Benefits/Costs of Electing the Fair Value Option

Trends in Fair Value Elections

SEC Reversals of Some Companies' Early FAS 159 adoptions

Complications Introduced for Company-specific and Industry-wide Financial Data Analysis

Questions

# Fair Value Option

Key Guidance in FAS 159



# SFAS 159 – The Fair Value Option

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- SFAS 159 provides for an option to elect fair value to initially and subsequently measure certain assets and liabilities at fair value
  - For certain financial assets and liabilities
  - On a contract by contract basis
  - Changes in fair value reflected in earnings
  - Elected initially or when an event gives rise to a new basis of accounting
  - Irrevocable election must be made (and documented) at time of initial recognition
  - All previously deferred fees and costs should be written off on initial adoption through the cumulative adjustment
- Effective for fiscal years beginning after 11/15/07 unless early adoption elected, which would also require early adoption of SFAS 157
- The difference between the carrying value and fair value of elected items upon the adoption date is a cumulative-effect adjustment to the opening balance of retained earnings

# FAS 159 Objectives

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- Expands the use of the fair value measurement attribute
- Provides an opportunity to mitigate volatility in earnings caused by a mixed attribute accounting model
- Improves financial reporting by reducing the need for complex hedge accounting
- Establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities
- Achieves greater convergence w/ international standards

# Scope – Included:

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Certain included items (newly eligible):

- Whole loans
- Debt
- Equity method investments (except for those with servicing elements)
- Firm commitments involving financial instruments
- Warranty rights and obligations
- Insurance and reinsurance contracts
- Loan commitments not accounted for as derivatives under SFAS 133

# Scope – Excluded:

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## Certain excluded items:

- Nonfinancial assets and liabilities
- An investment in a subsidiary that would otherwise be consolidated
- Deposit liabilities, withdrawable on demand
- Convertible debt with beneficial conversion features
- Assets and liabilities recognized under lease contracts
- Employer obligations for pension, other post-retirement benefits, employee stock option and purchase plan and other deferred compensation arrangements
- Income tax assets and liabilities
- Financial instruments that are, in whole or in part, classified in stockholder's equity by the issuer
- Interest in a VIE that is required to be consolidated

# Disclosures

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- When a statement of financial position is presented:
  - Management's reasons for electing each item, or group of similar items
    - If FVO is elected for only certain items within a group of eligible items, management's reasons for only electing certain items of the population
  - Information detailing the amounts impacted by election of FVO within financial statement line items
  - Aggregated differences between FV and unpaid balances relating to loans, long-term receivables, and long-term debt, for which FVO has been elected
  - For loans held as assets, the aggregated FV and principal value of loans >90 days past due

*\*\*\*See par. 18 & 19 in SFAS 159 for a comprehensive listing of disclosure requirements*

# Disclosures (cont'd)

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- When an income statement is presented:
  - Gains/losses attributable to changes in FV during the period of each line item & in which line such are reported
  - Methodology of measurement for interest and dividends, and where such amounts are recorded
  - If interest income is recognized separately from other changes in fair value, the aggregate fair value of loans on nonaccrual status
  - Gains/losses, and method of determination, related to changes in credit risk of loans, receivables and other liabilities, for which FVO has been elected
- Other Disclosures:
  - Disclosure requirements in other pronouncements are not eliminated
  - Annually, methods and significant assumptions used to estimate FV of items selected for FVO

*\*\*\*See par. 18 & 19 in SFAS 159 for a comprehensive listing of disclosure requirements*

# Fair Value Option

## Distinctions Between FAS 159 and 156



# FAS 159 and 156 Comparison

	<b>FAS 156</b>	<b>FAS 159</b>
Initial Recognition Trigger	<ul style="list-style-type: none"> <li>• Sale</li> <li>• Transfer to a QSPE in a GMS</li> <li>• Acquired or assumed</li> </ul>	<ul style="list-style-type: none"> <li>• Item is recognized</li> <li>• Firm commitment</li> <li>• Other subsequent triggers</li> </ul>
Documented Election	Election made for each “class” of servicing	Formally documented on election date or via a pre-existing policy for each “instrument”
Initial Recognition	<u>Must</u> be at fair value	If elected, at fair value. If not, follow other GAAP.
Subsequent Accounting	Option: <ul style="list-style-type: none"> <li>• If election made, fair value required (irrevocable for each class)</li> <li>• Amortization/impairment</li> </ul>	If election made, fair value required (irrevocable)

# Fair Value Option

## Benefits/Costs of Electing the Fair Value Option



# Benefits/Costs Comparison

<b>Benefits</b>	<b>Costs</b>
Mitigate earnings volatility due to mismatches in accounting models	If elected for liabilities, must incorporate a company's credit standing into the valuation of liabilities
Ease complexity of hedge accounting under FAS 133 (e.g., avoid operational difficulties associated with hedges of portfolios of mortgage loans held for sale)	Must be FULL fair value providing less of an advantage for fair value hedges of an identified portion of a hedged item
Reduces accounting differences for entities applying fair value option under IAS 39 and reconciling to US GAAP	Recognize up-front costs and fees in earnings (no deferral permitted)
Simplify accounting for certain items (e.g., loans) that may be impaired	System/Operational issues
Avoid one-sided result of LOCOM on held-for-sale loans	Extensive valuation and disclosure requirements
	Irrevocable (e.g., loans HFS that become un-saleable)
	Cash receipts and cash payments classified according to their nature and purpose (e.g., not all FVO investments would receive same cash flow treatment)

# Example – Loan Held for Sale

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- On 1/1/08, Bank A commits to lend in 90 days \$100,000 to Borrower Z for 10 years at a fixed rate of 10%, with annual principal payments of \$16,275
- The loan conforms to the criteria to be sold to a GSE (e.g., Fannie Mae and Freddie Mac)
- Bank A charges Borrower Z a commitment fee of \$500
- Bank A incurs \$1,500 in loan origination costs
- Bank A wishes to elect fair value for all originated and purchased loan assets that are held-for-sale (“HFS”) and hedges against changes in fair value of the loans between the date of origination/purchase and sale
  - The Company estimates that approximately 50% of its loan originations/purchases will be HFS (assume total annual production is expected to be 500,000 loans)

# Example – Loan Held for Sale (cont.)

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- Bank A followed FAS 91:
  - Origination costs representing salaries and other expenses are deferred systematically for all originated loans (held for sale and held for investment)
  - Commitment fees are also deferred
  - Net impact of the fees and costs are not amortized. Instead, the fees and costs are included in the carrying value of the loan, which becomes part of the basis for gain/loss on sale
- Assume the loan has a fair value of \$101,500 at origination and \$102,000 at 1/31/2008
- Assume Bank A sells the loan for \$102,500 to a GSE on 2/28/2008

**Note:** For simplicity, this example ignores the mark to market of the loan commitment under FAS 133, retained interests in securitization, or any proceeds other than cash (e.g., servicing rights).

# Example – Loan Held for Sale (cont.)

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- What should Bank A consider?
  - Impact on income statement geography
  - Timing of gain recognition
  - System capabilities, for example:
    - Current capabilities to defer FAS 91 costs and fees on certain loans and not others?
    - Are the fees and costs separate and transparent?
    - Does the system capture full fair value?
    - Required disclosure information readily available (e.g., changes in value due to instrument specific credit risk, non-accrual loans, etc.)?
  - Accounting if the loan becomes un-saleable (election is irrevocable)
  - Other unknown or unintended consequences
  - Although not in this example, should points, premiums, etc. be included in carrying value or immediately recognized in the income statement?

## Example – Loan Held for Sale (cont.)

	1/1/08	1/31/08	2/28/08
<b>Pre-FAS 159</b>	Loan \$101,000 Cash 101,000 Record funding net of fees and costs.	No entry required as the loan is not impaired under LOCOM.	Cash \$102,500 Gain on sale 1,500 Loan 101,000 Record sale.
<b>Post-FAS 159</b>	Loan \$100,000 Expense 1,500 Fee revenue 500 Cash 101,000 Record funding, salaries and other expense, and fee revenue. Loan \$ 1,500 Gain 1,500 Record mark to market.	Loan \$500 Gain 500 Record mark to market.	Cash \$102,500 Gain on sale 500 Loan 102,000 Record sale/mark to market.

## Example – Loan Held for Sale (cont.)

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- Overall Estimated Annual Impact for Company A
  - Increase in expenses of \$375M (\$1,500/loan times 250,000 loans)
  - Increase in fee revenue of \$125M (\$500/loan)
  - Increase in gain on sale/mark to market of \$250M due to not deferring above FAS 91
  - Increased volatility for loans that elect FVO and are not sold

# Example – Company's Own Credit

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- On 1/1/08, Company A issues \$100 million of 3-year 6.41% fixed-rate notes and enters into an at the market receive-fixed/pay-LIBOR interest rate swap to manage the risk associated with the fixed rate debt
- Company A may choose to hedge, to apply FVO, or to do neither

## Example – Company's Own Credit (cont.)

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- On 1/1/08, LIBOR is 6.41%
- On 12/31/08 (at the end of year 1):
  - LIBOR rises to 6.48%
  - The fair value change of the interest rate swap is \$(1,149,000)
  - The fair value change of the fixed rate debt due to changes in LIBOR and changes in Company A's creditworthiness is \$1,500,000—a gain
  - The portion of the fair value change in the debt attributable to Company A's creditworthiness is \$351,000

# Example – Company’s Own Credit (cont.)

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## End of Year 1 – Income Statement Impact (000s)

No FVO / No Hedge		Hedge Interest Rate Risk (assuming 100% effective)		FVO Elected	
Interest expense	\$6,500	Interest Expense	\$6,500	MTM debt net (\$6,500 - \$1500)*	\$5,000
		MTM Debt for changes in IRR	(1,149)		
MTM interest rate swap	<u>1,149</u>	MTM interest rate swap	<u>1,149</u>	MTM interest rate swap	<u>1,149</u>
Net impact	\$7,649	Net impact	\$6,500	Net impact	\$6,149

***\*Note that FAS 159 does not provide guidance on recognizing and measuring interest expense separate from other changes in fair value.***

# Example – Company’s Own Credit (cont.)

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## End of Year 1 – Balance Sheet Impact (000s)

<b>No FVO / No Hedge</b>		<b>Hedge Interest Rate Risk</b>		<b>FVO Elected</b>	
Derivative Liability	\$(1,149)	Derivative Liability	\$(1,149)	Derivative Liability	\$(1,149)
Debt at principal amount	\$(100,000)	Debt (adjust basis for change in LIBOR)	\$(98,851)	Debt (adjust basis for total change in FV)	\$(98,500)
Accrued Interest	<u>\$(6,500)</u>	Accrued Interest	<u>\$(6,500)</u>	Accrued Interest	<u>\$(6,500)</u>
Total Liabilities	\$(107,649)	Total Liabilities	\$(106,500)	Total Liabilities	\$(106,149)

# Fair Value Option

## Trends in Fair Value Elections



# Examples of Large Banks

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Bank	Early Adopted?	Instruments Elected
Bank of America	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Mitigate earnings volatility and eliminate hedge accounting for certain instruments)</p>	<ul style="list-style-type: none"> <li>• Certain large corporate loans and loan commitments</li> <li>• Certain fixed-rate HFS loans</li> <li>• AFS debt securities</li> <li>• Structured reverse purchase agreements</li> <li>• Long-term deposits</li> </ul>
Bear Stearns	<p style="text-align: center;">No</p>	<p>N/A – only early adopted FAS 157</p>
Citigroup	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Mitigate earnings volatility)</p>	<ul style="list-style-type: none"> <li>• Convertible preferred equity</li> <li>• Certain repurchase and resale agreements</li> <li>• Certain short term borrowings</li> <li>• Certain LOCs</li> <li>• Certain loan products</li> <li>• Certain investments in PE and Real Estate ventures</li> <li>• Certain structured liabilities</li> <li>• Certain equity-method investments</li> </ul>

# Examples of Large Banks (cont.)

Bank	Early Adopted?	Instruments Elected
Credit Suisse	<p>Yes</p> <p>(Simplification and economic hedges not meeting FAS 133 hedging criteria)</p>	<ul style="list-style-type: none"> <li>• Structured and matched books resale agreements</li> <li>• Certain equity method investments</li> <li>• Certain IB corporate and emerging market loans</li> <li>• Loan commitments</li> <li>• New loans and new VIEs (as of 1/1/07)</li> <li>• Emerging markets time deposits</li> <li>• Fund-linked deposits</li> <li>• Fixed rate debt</li> <li>• Hybrid debt instruments with embedded derivative features</li> </ul>
Goldman Sachs	<p>Yes</p> <p>(Mitigate earnings volatility, cost benefits, and simplification)</p>	<ul style="list-style-type: none"> <li>• Certain unsecured short-term borrowings</li> <li>• Certain other secured financing</li> <li>• Certain unsecured long-term borrowings</li> <li>• Resale and repurchase agreements</li> <li>• Securities borrowed and loaned</li> <li>• Securities held by bank subsidiary</li> </ul>

# Examples of Large Banks (cont.)

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Bank	Early Adopted?	Instruments Elected
JP Morgan Chase	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Mitigate earnings volatility and instruments risk managed on a fair value basis)</p>	<ul style="list-style-type: none"> <li>• Certain loans from principal investing</li> <li>• Certain HFS loans</li> <li>• Loan originations and purchases for securitization warehousing</li> <li>• Certain resale and repurchase agreements</li> <li>• All structured notes eligible for FV under FAS 155</li> </ul>
Lehman Brothers	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Ease complexity of hedge accounting)</p>	<ul style="list-style-type: none"> <li>• Structured notes not subject to FAS 155</li> <li>• Deposits at US banking subsidiaries</li> </ul>

# Examples of Large Banks (cont.)

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Bank	Early Adopted?	Instruments Elected
Merrill Lynch	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Instruments risk managed on a fair value basis and elimination of hedge accounting)</p>	<ul style="list-style-type: none"> <li>• Fixed rate AFS securities</li> <li>• Auto and corporate loans</li> <li>• Certain receivables under resale agreements</li> <li>• Certain payable under repurchase agreements</li> <li>• Certain long-term borrowings, including structured debt</li> </ul>
Morgan Stanley	<p style="text-align: center;">Yes</p> <p style="text-align: center;">(Mitigate earning volatility, cost benefits, and simplification)</p>	<ul style="list-style-type: none"> <li>• Hybrid financial instruments (instead of using FAS 155)</li> <li>• Equity method investments</li> <li>• Interests in clearinghouses</li> <li>• Brokered and callable CDs</li> <li>• Loans and financial instruments not subject to accounting by broker dealers or investment companies</li> </ul>

# Fair Value Option

SEC Reversals of Some Companies' Early FAS 159

Adoptions



# Questionable Strategies

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## Example 1:

- At adoption, Company elects the FVO for financial assets in unrealized loss positions (e.g., AFS securities)
  - Unrealized losses at adoption of FAS 159 is a component of cumulative-effect adjustment to beginning retained earnings
- Soon after adoption, Company sells those assets
- The proceeds from the sale are used to purchase other assets (sometimes the same or substantially similar) and Company does NOT elect FVO
- Result: Company has avoided losses and increased its earning in future periods because of higher yields on the replacement investment assets

# Questionable Strategies (cont.)

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## Example 2:

- At adoption, Company elects the FVO for callable debt whose carrying value is less than the call price and fair value of the debt
  - Unrealized losses at adoption of FAS 159 is a component of cumulative-effect adjustment to beginning retained earnings
- Soon after adoption, Company calls and extinguishes the debt
- Company obtains proceeds for the extinguishment by issuing new debt at a lower coupon that will NOT be accounted for at fair value
- Result: Company has avoided losses and increased its earnings in future periods because of lower coupons on replacement debt

# SEC Response to Sale Strategies

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## SEC Staff Informal Thoughts

- Expressed concern to accounting firms that certain proposed accounting for a sale and/or extinguishment strategy results in financial reporting that is not transparent
- Indicated it may question financial reporting that does not appear consistent with the objective and spirit of FAS 159
- If accounting for a sale or extinguishment strategy is appropriate, disclosures to provide transparency should be provided

Note: In a 2004 speech, a former deputy chief accountant of the SEC stated:

“It is in fact true that the accounting for some...transactions is clear under the literature, and the structuring therefore works. However, I am suggesting that whether these arrangements achieve their accounting goals or not, employing them is not in the best interests of investors, does not promote transparency, and is evidence of the fact that the focus on compliance undermines quality financial reporting.”

# Disclosures for Sale Strategies

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FAS 159 requires disclosures (not all-inclusive):

- Reasons for electing a FVO for each eligible item or group of similar items
- If not elected for similar items, the reasons for partial election and information to understand how the group of similar items relates to individual line items in the balance sheet

Based on SEC concerns, also consider other disclosures, such as:

- A description of the sale strategy including how soon after the election they were sold or extinguished
- Information about how the proceeds were used and how similar the purchased assets were (or the similar of new debt issued)
- A statement that enhanced yields or lower on its portfolio (or decreased expense on its debt) in future periods will result
- The amount of unrealized loss in the cumulative-effect adjustment related to the strategy

# Other Considerations Related to Sale Strategies

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## OTTI impairment of assets

- Should unrealized losses have been recorded in earnings of the prior period (e.g., does the Company have the intent and ability to hold the securities until recovery as required by applicable other-than-temporary impairment guidance)

## Corporate Governance

- Discuss with audit committee strategy and related disclosures

# Fair Value Option

Complications Introduced for Company-specific  
and Industry-wide Financial Data Analysis



# Where Has Comparability Gone?

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## Income Statement

- Gain on sale of loans
- Salaries and other expense
- Fees on loans/other revenue
- Acceleration of gains/losses on commitments, loans, and securities
  - If SAB 105 is repealed, for loan commitments that are derivatives
  - Election to fair value loan commitments that are not derivatives
- No uniform guidance on how interest income is measured
- Income tax expense
- Timing of elections (company to company and instrument by instrument)

# Where Has Comparability Gone? (cont.)

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## Balance Sheet

- No valuation allowance for loans held for investment (that elected FVO)
- All AFS and HTM electing FVO must be classified as trading
- Commitments can be fair valued
- Tax obligations

## Disclosures

- Differences between companies

# Other Complications

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- No other-than-temporary test for instruments under the FVO
- Impact to risk-based capital

# Questions?

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