Special Report

Spotlight on the Fair Value of Loans

A Focus on U.S. Banks

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Related Research

- *Accounting and Financial Reporting: 2009 Global Outlook, Jan. 8, 2009*
- *Fair Value Accounting: An Overview of the Requirements, Jan. 24, 2008*

Further accounting research is available in the Accounting and Corporate Governance section of www.fitchratings.com.

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Overview

Two major changes to the financial reporting of loans are moving through the standard-setting "pipeline" in the U.S. The first change will significantly expand and improve disclosures about the allowance for credit losses, the credit quality of loans, and the fair value of loans.

The second change, which would likely be subject to intense debate, would require all financial instruments, including loans, to be measured on the balance sheet at fair value. The fair value proposal will affect the balance sheets of most banks in a very significant way, with possible repercussions on bank analysis and bank capital, depending on the regulatory response to any accounting change.

With the looming changes in mind, this report explores the fair value disclosure of bank loans over the past 10 years, with a view to determining whether the fair value of loans derived from current disclosure provides a leading, lagging, or coincident indication of credit losses. In addition, the report analyzes how the fair value of loans would affect the total shareholders' equity of the 20 largest publicly traded U.S. banking institutions at the end of September 2009.

Fitch finds that because of the quality of the disclosures provided to date, as well as the inherent judgment required to determine the fair value of loans — due to a lack of liquid markets for such instruments and the need to rely mostly on internal models — historical fair value numbers were mostly consistent with management's loan loss estimate incorporated in the net book value (net of allowance for loan losses) measured at amortized cost on the balance sheet.

Key Findings

- The weighted average fair value of loans for the 20 banks in Fitch's sample declined from a multiyear high of 102.5% of net book value at Dec. 31, 2002, to a multiyear low of 95.4% as at June 30, 2009.
- Hypothetically, if the proposal for loans were adopted in the third quarter of 2009, it would result in a decrease in shareholders' equity of $130 billion (approximately 14% of the combined total equity of all the 20 banks reviewed). This reduction excludes offsets from applying fair value to the liabilities that fund the loans.
- Loans made up an average 54% of the total assets of the banks reviewed, with less than 2% of total loans outstanding currently measured at fair value.
- From the data gathered, it is difficult to establish a set long-term trend between the deterioration in the fair value of net loans disclosed by the banks reviewed and loan loss/net chargeoff metrics. Therefore, interpreting differences between the fair value and the carrying amount of loans is ambiguous at best.
- Significant disparities were noted in how banks currently measure the fair value of their loan portfolios. In addition, the lack of disaggregation in current disclosure on the fair value of loans hinders comparability and analysis.

Background

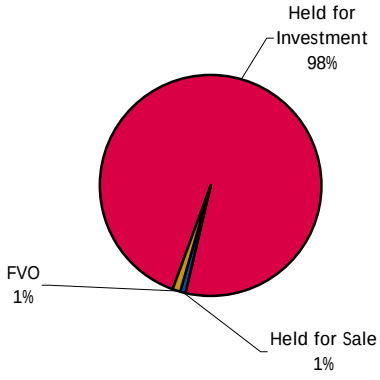
Current Accounting for Loans

Today, the accounting for loans is a hodgepodge of accounting guidance based on a myriad of factors, including the bank's intended holding period of the loan, the type of financial institution issuing the loan, whether the loan is purchased or originated, whether the loan is considered restructured or impaired, and other factors. Generally, banking institutions can classify a loan as either held for sale or held for investment, or it can utilize the fair value option.

- Loans held for sale are reported on the balance sheet at the lower of cost or market (LOCOM). This means that the loans are measured at amortized cost unless the market value falls below the cost measurement; if the market value falls below cost, the loan is written down to cost. These loans are typically "warehoused" for sale via a securitized transaction.
- Loans are classified as "held for investment" when the bank has both the intent and the ability to hold the loan for the foreseeable future or until maturity. These are measured at amortized costs with an allowance account established for estimated future loan losses.
- In 2007, the accounting standard on the fair value option (FVO) was issued. This standard effectively gave banks the option to mark loans to fair value every quarter with changes in fair value recorded on the income statement.

As noted in the chart at right, at Sept. 30, 2009, 98% of loans held by the 20 banks reviewed were classified as held for investment and therefore measured at amortized cost. One percent of the loans were classified as held for sale and another 1% of loans utilized the fair value option. Loans currently make up 55% of total assets, based on the average for banks in the sample.

Classification of Loans
(As of Sept. 30, 2009)



Source: Fitch, quarterly filings.

Proposed Accounting for Loans

The Financial Accounting Standards Board (FASB) is expected to unveil a new financial instruments proposal in the first quarter of 2010. The proposal would require all financial instruments, including loans, to be measured on the balance sheet at fair value. In addition, the proposal would abolish the "held for sale" and "held for investment categories" in current accounting for loans. The proposal would allow for two primary classifications.

- Fair Value Through Net Income. This category would be the default category for all financial instruments including loans unless certain criteria are met (see primary criteria below). It would include derivatives, equity investments, and others.
- Fair Value through Other Comprehensive Income (OCI). This category would allow a company to recognize fair value gains and losses through OCI if:
  - The business model and management's intention is to hold the financial

instruments for collection or payment of cash flows rather than selling for capital gains.

- The variability of the cash flows associated with the financial instrument is low. Therefore instruments such as derivatives would likely not meet this criterion while fixed income instruments would.
- Loans and fixed income instruments would likely be the dominant instruments in this category. Reclassifications from one "bucket" to another will not be permitted.

The presentation of financial instruments on the face of the balance sheet and income statement also changes, two notable changes are expected.

- The balance sheet would present separate line items for amortized cost and fair value. With this dual presentation, an analyst could easily choose the number that is most relevant for their analysis.

Amortized Cost	XXXX
Less Allowance	(xxx)
+-Fair Value Adjustment	XXXX
Net Loans	xxxx

- OCI would now be shown on the same page below net income and be called a statement of comprehensive income. The FASB's intention is to make OCI a more prominent feature so that the fair value changes going through OCI have equal visibility to analysts and investors.

With regards to the timeline, the proposal is expected to be issued in the first quarter of 2010 with final implementation not expected before 2011.

Going Back in Time on the Fair Value of Bank Loans

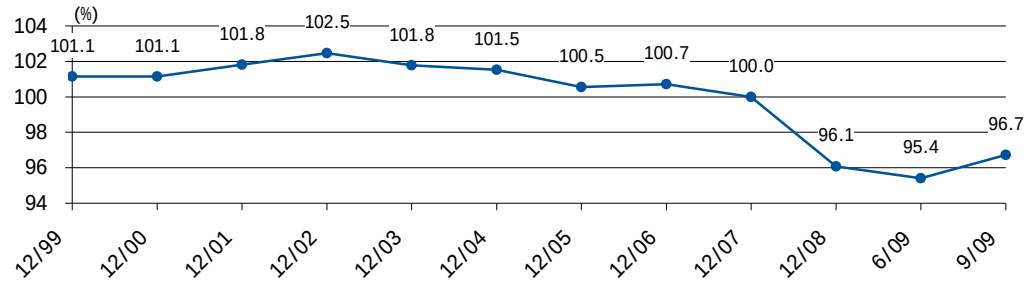
In 1991, the FASB issued SFAS 107, "Disclosure about Fair Value of Financial Instruments," now ASC 825-10-50-10. This standard required all companies to disclose the fair value of all financial assets and liabilities. Thus, the fair value of assets and liabilities typically carried at amortized cost (loans, deposits, and long-term debt) was required to be disclosed annually. In April 2009, the FASB amended SFAS 107 disclosures to require the disclosure of the fair value of financial assets and liabilities for all interim and annual periods.

Over the years, the disclosure of the fair value of financial instruments, including loans, has garnered little attention. This was primarily due to the fact that the fair value of loans was generally higher than the carrying amount. However, the significant market deterioration over the past two years has led to a significant downswing in the fair value of many banks' loan portfolios relative to their book value, net of allowance for loan losses.

As noted earlier, Fitch reviewed the fair value disclosures of 20 large banks in the U.S. This review showed some interesting trends. As shown in the chart below, the weighted average fair value of loans declined from a multiyear high of 102.5% of net book value at Dec. 31, 2002, to a multiyear low of 95.4% as at June 30, 2009.

Hypothetically, if the proposal for loans was adopted in the third quarter of 2009, it would result in a decrease in shareholders' equity of $130 billion (approximately 14% of the combined total equity of all the 20 banks reviewed). This reduction excludes offsets from applying fair value to the liabilities that fund the loans.

Fair Value as a Percentage of Net Book Value



Source: Fitch, quarterly and annual filings.

Fitch notes that the decrease in fair value as at Sept. 30, 2009 was primarily concentrated in the loan portfolios of five banks.

How Are Banks Measuring the Fair Value of Loans?

In assessing the fair value of loans held for investment, active markets are mostly lacking. Therefore most banks apply a discounted cash flow analysis using rates currently being offered in the market with similar credit quality, terms, and maturities to borrowers. This calculation sometimes adjusts for unique factors that the bank believes a market participant would consider in determining the exit value/fair value, including prepayment estimates for the life of the loan, default rates, loss severity, liquidity risk, prepayment estimates, and other factors.

The measurement of the fair value of loans for most of the banks in Fitch's sample is in line with the general description above. A typical disclosure of the methodology is the Capital One example below.

Capital One Financial Corp, 10Q; Sept. 30, 2009

The fair values of credit card loans, installment loans, auto loans, mortgage loans and commercial loans were estimated using a discounted cash flow method, a form of the income approach. Discount rates were determined considering rates at which similar portfolios of loans would be made under current conditions and considering liquidity spreads applicable to each loan portfolio based on the secondary market.

Although the use of secondary market prices to value loans by the banks in Fitch's sample was limited, a few banks disclosed the limited use of quoted secondary loan market prices in valuing some part of their loan portfolios.

Northern Trust, 10Q; September 30, 2009

The fair values of one-to-four family residential mortgages were based on quoted market prices of similar loans sold, adjusted for differences in loan characteristics. The fair values of the remainder of the loan portfolio were estimated using a discounted cash flow method in which the interest component of the discount rate used was the rate at which Northern Trust would have originated the loan had it been originated as of the date of the consolidated financial statements.

In some cases the method employed did not conform to the exit price concept of SFAS 157 /ASC 820-10. For example, Citigroup noted the following.

Citigroup Inc., 10Q; Sept. 30, 2009

For loans with doubt as to collectability, expected cash flows are discounted using an appropriate rate considering the time of collection and the premium for the uncertainty of the flows. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820-10 (SFAS No. 157).

Many banks disclosed the factors that contributed to the general decline in fair value. The primary reason disclosed by many banks was the effect of illiquidity, as described by Capital One and Regions Financial Corp. below.

Capital One Financial Corp, 10Q; Sept. 30, 2009

The decrease in fair value below carrying amount at Dec. 31, 2008 is primarily due to the significant level of illiquidity in the secondary market experienced during 2008. During 2009 these markets have begun to recover resulting in an improvement in the fair value of our loans held for investment. The most significant discounts to carrying amount were seen in the Company's commercial and mortgage portfolios.

Regions Financial Corporation, 10Q; Sept. 30, 2009

The estimated fair value of portfolio loans assumes sale of the notes to a third-party financial investor. Accordingly, the value to the Company if the notes were held to maturity is not included in the fair value estimate. In the current whole loan market, given the lack of market liquidity, financial investors are generally requiring a much higher rate of return than the return inherent in loans if held to maturity. This divergence accounts for the majority of the difference in carrying amount over fair value.

Timing also plays an important role. For loans with remaining average maturity of less than one year, carrying amount on the loan balances were used as an approximation of the fair values. In Fitch's sample, State Street Corporation has maintained the fair value of loans and the net book value of loans at 100% over the past 10 years. This very stable valuation is not typical, and State Street attributed it to the short duration of the bank's loan portfolio.

State Street Corporation, 10Q; Sept. 30, 2009

In addition, due to the relatively short-term nature of the majority of our net loans (excluding leases), the majority of which has short durations, we have determined that their fair value approximates their reported value.

Some banks were of the opinion that the fair value of their loan portfolios did not represent the "true value" of the loan portfolio when held to maturity. For example, SunTrust Bank, in the exhibit on the following page, noted why it did not think the loan values provided an estimate of long-term credit losses on its loan portfolio.

SuntrustBanks Inc, 10Q; Sept. 30, 2009

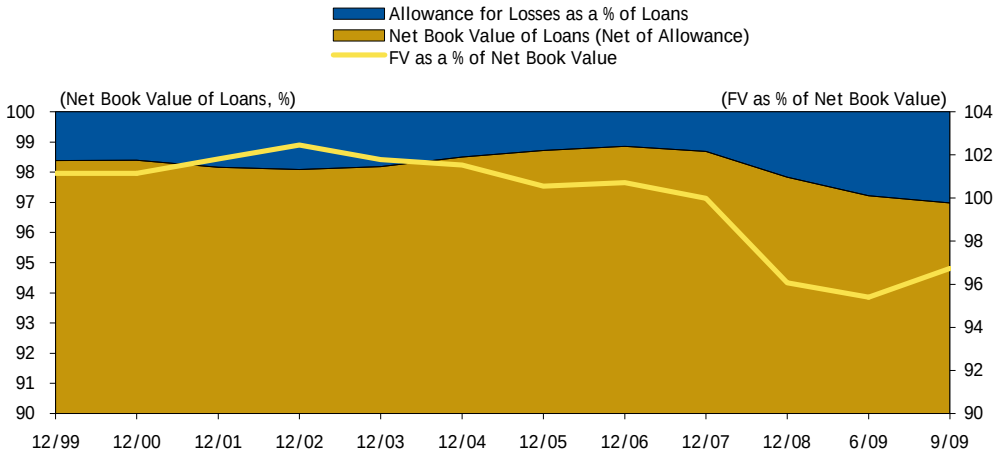
Loan fair values are based on a hypothetical exit price, which does not represent the estimated intrinsic value of the loan if held for investment.

The Company estimated fair value based on estimated future cash flows discounted, initially, at current origination rates for loans with similar terms and credit quality, which derived an estimated value of approximately 99% and 98% on the loan portfolio's net carrying value as of Sept. 30, 2009 and Dec. 31, 2008, respectively. The value derived from origination rates likely does not represent an exit price due to the current distressed market conditions; therefore, an incremental market risk and liquidity discount, was subtracted from the initial value to reflect the illiquid and distressed market conditions as of Sept. 30, 2009 and Dec. 31, 2008, respectively. The discounted value is a function of a market participant's required yield in the current environment and is not a reflection of the expected cumulative losses on the loans.

Did Fair Value of Loans Provide Early Warning Signs of Impending Loan Losses?

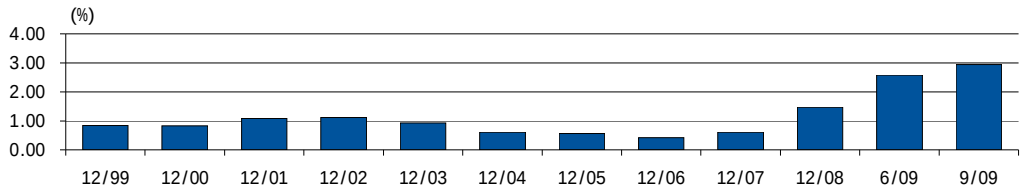
With the benefit of hindsight, can analysts say the fair value of loans, as reported in the financial statements of the banks reviewed, provided early warning signs with regard to the credit losses most loan portfolios are currently experiencing? Did the fair value of loans prove to be an indicator of credit losses prior to the full exposure of the subprime crisis?

Net Book Value and Fair Value of Loans



Source: Fitch, company filings.

Net Chargeoff Trends



Source: Fitch, quarterly and annual filings.

From the data gathered, it is difficult to establish a set long-term trend between the deterioration in the relative fair value of net loans disclosed by the banks reviewed and loan loss/net chargeoff metrics. Therefore, interpreting differences between the fair value and the carrying amount of loans is more of an art than a science.

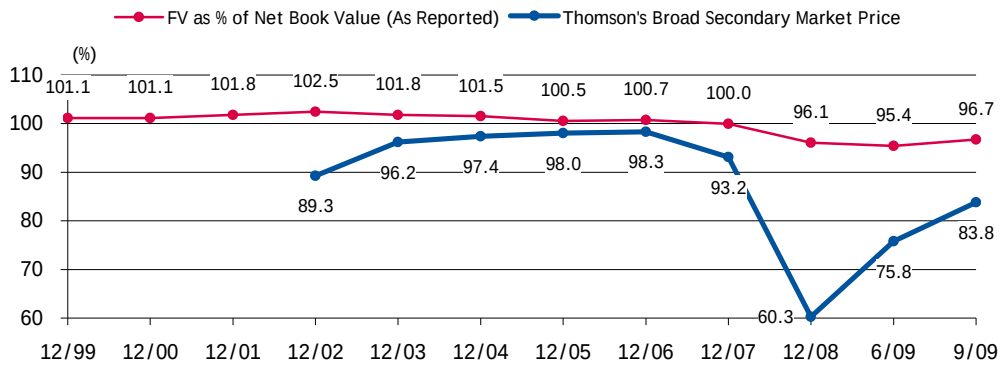
According to current GAAP, the net book value of loans held for investment should only reflect incurred losses, while the fair value is expected to incorporate estimated future losses. Therefore, a lower fair value to the net book value of a loan portfolio could imply that management expects future loan losses to increase. It could also be construed to mean that loan loss reserves are not large enough or the fair value estimates are too conservative.

Directionally, fair value measures appear to track net increases and decreases in loan loss reserves and net chargeoff metrics. However, a marked exception is obvious between December 2001 and December 2003. Surprisingly, this period witnessed an increase in the fair value of loans in contrast with increasing loan provisions and net chargeoffs in the aftermath of the brief recession experienced in 2001.

Comparing Reported Fair Value of Loans to Broad Secondary Loan Market Benchmark

Broadly, Fitch noted a distinct divergence between the fair value of a broad secondary loan market benchmark and the average fair value of loans reported by the 20 banks reviewed.

Fair Value (as Reported) Vs. Broad Secondary Loan Market Benchmark



Source: Fitch and company filings, Thomson Reuters.

This divergence could be attributed to a number of factors, including:

- The limited use of secondary market data in valuing loan portfolios. Thus, the fair value valuations are based primarily on internal models — i.e. Level 2 or Level 3 — and the assumptions and methodology of Level 3 valuations can be subjective.
- According to some banks, the primary driver of the differences in fair value and carrying value is liquidity risk. Therefore, the very sharp drop in secondary market prices at December 2008 may have been primarily a reflection of the extraordinary seizure experienced by global credit markets in the third quarter of 2008.
- Some banks may not be fully applying the exit value notion of fair value in the reported numbers.

Is the Fair Value of Loans Helpful to Analysis?

Currently, the fair value of loans is disclosed as a line item in the notes to the financial statement with no granularity or disaggregation. Therefore, commercial, residential, and consumer loans are all lumped together on one line. Furthermore, the valuations of impaired loans, purchased loans at fair value, and performing originated loans are also not disaggregated. These are loans with very different characteristics and are often analyzed separately, when the information is provided. The disclosure of the methodology and assumptions applied to the loan valuation process mostly appears to be boilerplate and typically lacks any insight into the main drivers of loan values. Comparability is therefore hindered and the disclosure, or lack thereof, tends to present more questions than answers.

In response to this lack of comparability, the FASB's proposal to require further disaggregation is a step in the right direction.

Proposed FASB Disclosure Should Be Helpful

As part of a broader proposal to enhance disclosures about the allowance for credit losses and the credit quality of financing receivables, FASB is proposing the requirement to disclose the fair value of loans by portfolio segment. In addition, it is mandating the disclosure of the methods and significant assumptions used in the valuation process.

The improved disaggregation should help isolate trends and — if the disclosure of the methods and significant assumptions used in the valuation process is robust — more insight would likely be gleaned by analysts. See the sample of proposed quantitative disclosure provided by the FASB in the table below.

Analysis of the Financing Receivable Activity — 2010

($)

	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Individually Evaluated Impaired Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Beginning Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Originations	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Sales/Repayments	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Charge-Offs	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Transfers To/From Collectively Impaired	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Ending Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Fair Value Of Ending Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Collectively Evaluated Impaired Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Beginning Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Originations	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Sales/Repayments	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Charge-Offs	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Transfers To/From Collectively Impaired	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Ending Balance [a, b]	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Fair Value Of Ending Balance	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX

[a] Not including $XX,XXX of financing receivables measured at fair value. [b] Not including $XX,XXX of financing receivables measured at LOCOM.
Source FASB.

A Deeper Dive into the Numbers

Regional Banks

There were 20 banks in Fitch's sample, 13 of which were regional banks. Loans made up an average of almost 65% of the total assets of these banks and the average fair value of loans was 94%, with a range of 81% (Regions Financial) to 99.9% (Comerica).

Regional Banks Summary Loan Data

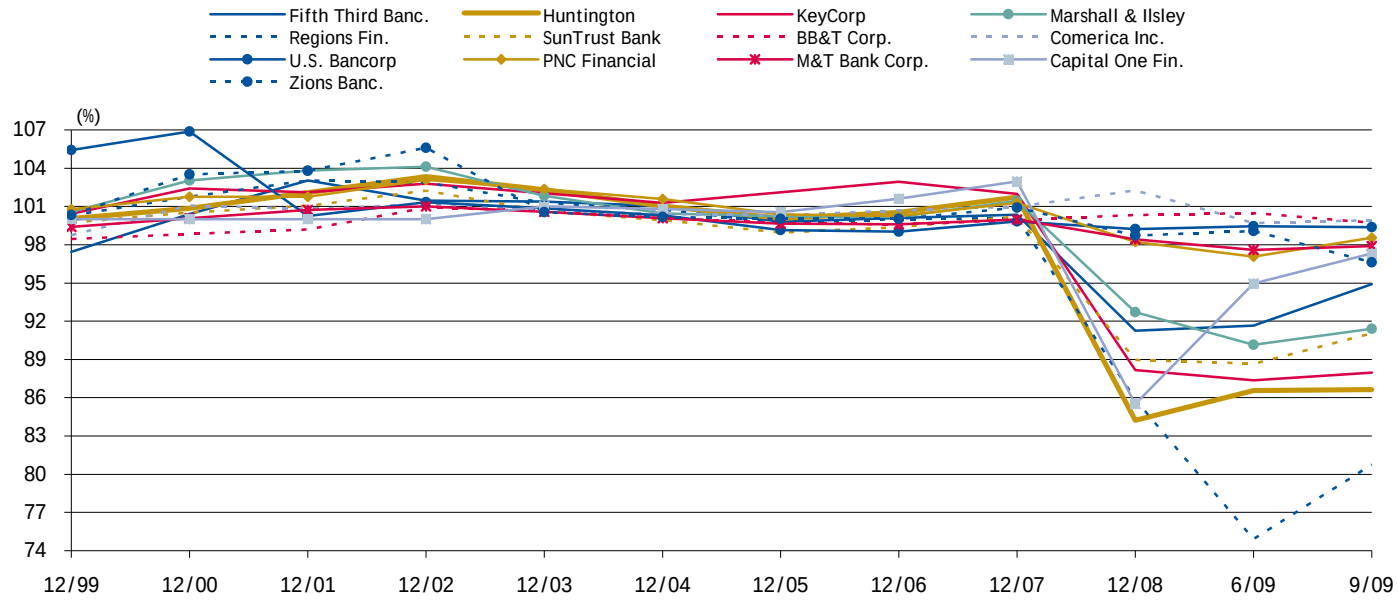
($ Mil., As of Sept. 30, 2009)

Banks	Book Value	FV of Loans	Difference	FV as a % of BV	Total Assets	BV of Loans to TA	Total Equity	FV Diff. as a % of Total Equity
BB&T Corporation	101,565	101,300	(265)	99.7	165,328	61.4	16,142	(2)
Capital One Fin.	92,270	89,809	(2,461)	97.3	168,504	54.8	26,222	(9)
Comerica Inc.	42,618	42,587	(31)	99.9	59,590	71.5	7,035	0
Fifth Third Bancorp	74,722	70,917	(3,805)	94.9	110,740	67.5	13,688	(28)
Huntington Banc.	36,272	31,425	(4,848)	86.6	52,513	69.1	5,675	(85)
KeyCorp	59,708	52,523	(7,185)	88.0	96,989	61.6	11,188	(64)
M&T Bank Corp.	51,336	50,253	(1,083)	97.9	68,997	74.4	7,612	(14)
Marshall & Ilsley	44,693	40,848	(3,845)	91.4	58,545	76.3	6,402	(60)
PNC Fin. Services	149,515	147,361	(2,154)	98.6	271,407	55.1	31,663	(7)
Regions Fin. Corp.	87,552	70,693	(16,859)	80.7	139,986	62.5	18,492	(91)
SunTrust Banks, Inc.	113,464	103,301	(10,163)	91.0	172,718	65.7	22,908	(44)
U.S. Bancorp	178,231	177,128	(1,103)	99.4	265,058	67.2	25,880	(4)
Zions Bancorporation	40,447	39,079	(1,367)	96.6	53,404	75.7	5,524	(25)

Source: Fitch, quarterly filings.

Given that the loan portfolios of most regional banks are fairly comparable with a real estate loan concentration, two questions arise: Why the differences in fair value, and can the differences in fair value be explained? Unfortunately, this again brings to the fore the limitations of current disclosure discussed earlier in this report. The lack of granularity makes it almost impossible to explain whether the differences are due to the credit quality of the loan portfolios or if other idiosyncratic factors are in play.

Regional Banks — Fair Value as a Percentage of Net Book Value



Source: Fitch, quarterly and annual filings.

Taking a look at the fair value of loans for the regional banks in the chart on page 9, it is clear that the values have all moved in the same direction over the past 10 years. The fair values mostly stayed above 100% until December 2007, when the markets experienced a significant deterioration.

Money Center Banks

Among the "money center" banks, the decline in fair value as a percentage of net book value was relatively mild particularly for JP Morgan and Citigroup. It is difficult to narrow down the primary reason for the differences. However, Wells Fargo's approximately 60% real estate concentration may have contributed to its $22 billion difference in net book value and fair value. At Bank of America, the real estate portfolio (residential, home equity, and commercial real estate) made up almost 51% of approximately $900 billion in loans.

Money Center Banks Summary Loan Data

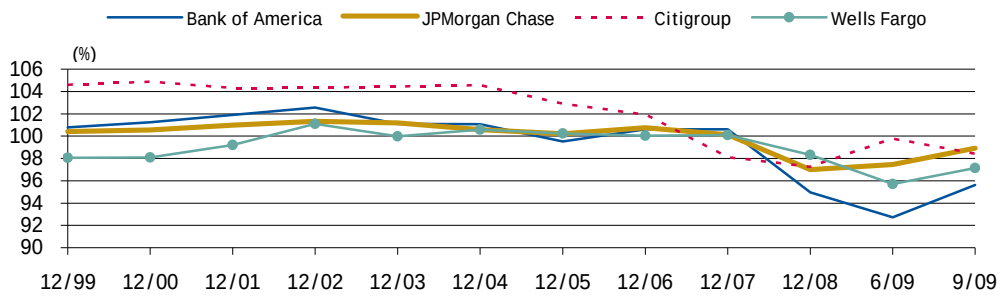
($ Mil. As of Sept. 30, 2009)

Banks	Book Value	FV of Loans	Difference	FV as a % of BV	Total Assets	BV of Loans to TA	Total Equity	FV Diff. as a % of Total Equity
Bank of America	856,779	819,134	(37,645)	95.6	2,251,043	38.1	257,683	(15)
JPMorgan Chase & Co	622,500	615,800	(6,700)	98.9	2,041,009	30.5	162,253	(4)
Citigroup	582,700	573,600	(9,100)	98.4	1,888,599	30.9	142,949	(6)
Wells Fargo & Company	775,924	753,821	(22,103)	97.2	1,228,625	63.2	128,924	(17)

Source: Fitch, quarterly filings.

Reviewing the data of the past 10 years, it is notable that Citigroup maintained a sizable margin until December 2006, while Bank of America experienced a sizable discount to its net book values relative to other money center banks after December 2008.

Money Center Banks — Fair Value as a Percentage of Net Book Value

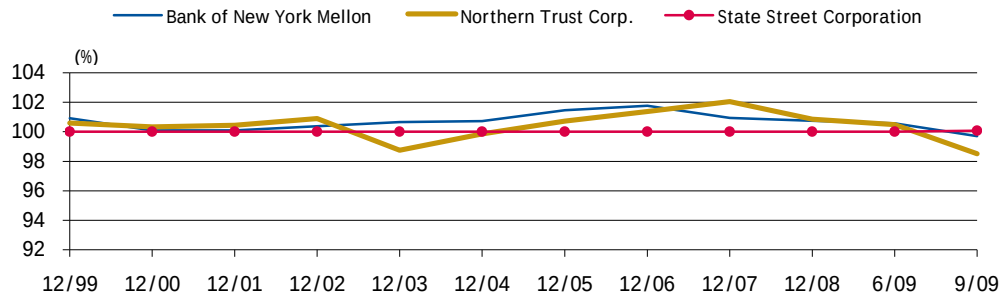


Source: Fitch, quarterly and annual filings.

Trust and Custodial Banks

The three trust and custodial banks in Fitch's sample have maintained relative stability in the fair value of their loan portfolios over time, particularly State Street Bank.

Trust and Custodial Banks — Fair Value as a Percentage of Net Book Value



Source: Fitch, quarterly and annual filings.

Trust and Custodial Banks Summary Loan Data

($ Mil., As of Sept. 30, 2009)

Banks	Book Value	FV of Loans	Difference	FV as a % of BV	Total Assets	BV of Loans to TA	Total Equity	FV Diff. as a % of Total Equity
Bank of New York Mellon	32,239	32,538	299	100.9	212,007	15.2	28,316	1.1
Northern Trust Corp.	26,806	26,965	159	100.6	77,901	34.4	6,223	2.6
State Street Corp.	9,664	9,664	—	100.0	163,277	5.9	13,440	0.0

Source: Fitch, quarterly filings.

The relative stability of State Street's portfolio can be attributed in part to the fact that lending is primarily not a primary focus of its business model and real estate loans make up an insignificant part of its portfolios. Generally, for State Street and BONY, lending is primarily in the form of short-term loans that provide liquidity to top customers in support of their investment transaction flows. However, Northern Trust maintains a $10.8 billion residential real estate portfolio and a $3.1 billion commercial real estate portfolio.