

2007 AICPA National Banks & Savings Institutions Conference



Regulatory Update
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Presentation Topics

- Fair Value Accounting
 - Overview and Supervisory Concerns
 - Project to Issue Supervisory Guidance
 - FRB Staff Study on Commercial Loan Fair Value Practices
 - FVO Adoption by Banking Organizations
 - Valuation During Market Stress
- International Accounting and Reporting
 - IFRS to U.S. GAAP Reconciliation
 - Basel Committee on Banking Supervision Accounting Task Force Update
- Basel II (brief overview and update)



Fair Value Accounting



Fair Value Accounting

- Major issue in accounting circles – moving to fair value accounting model from existing historical cost (“mixed-attribute”) model
 - Fair value (market value) represents an estimate of what an asset can be sold for or a liability transferred
 - Generally, changes in value recognized in current earnings



Fair Value Accounting Trend to Fair Value Accounting

- Trading accounts
- Securities “available-for-sale” (adjustment to equity)
- Derivatives
- Impairments (write-downs) often based on fair values
- Footnote disclosure of fair values for all financial instruments
- “Fair value option” for most financial instruments, including loans and some liabilities (FAS 159); also for servicing rights
- Fair value measurements – “how to” guidance on fair values (FAS 157)



Fair Value Accounting Standard-setters Long-term View

- FASB and IASB support fair value accounting for all financial assets and liabilities as a long-term objective – Advantages include
 - Relevant, current information
 - “Principles-based” and less complex (in concept)
 - Comparable approach to valuation (in concept)
 - Market risks reflected in primary financial statements



**Fair Value Accounting
Federal Reserve Perspective**

- Longstanding support for fair value accounting for actively traded positions and fair value disclosure for other financial assets and liabilities
- Fair value accounting for all financial instruments has conceptual appeal
- However, numerous issues and concerns need to be evaluated and addressed before considering a fair value requirement for all financial instruments



**Fair Value Accounting
Issues and Concerns**

- Reliability
 - Especially for non-traded, illiquid financial instruments
 - Fair values for loans, commitments, deposits, and even some securities can vary widely based on the valuation inputs and methodology used
 - Smaller institutions



Fair Value Accounting Issues and Concerns

- Potential for management bias in estimation
- Verifiability
 - Difficult for increasingly complex and illiquid financial instruments, especially those based on unobservable market pricing
 - Auditors and supervisors may need to understand, test, and rely more on the controls surrounding the fair value estimates
 - Third party valuation expertise



Fair Value Accounting Issues and Concerns

- Relevance issues
 - Performance measurement – “core” earnings versus “noncore” effects
 - Stressful economic or market conditions or “froth”
 - Credit risk on firm’s own liabilities
 - Unsettled, fundamental issues regarding valuation of certain complex instruments (e.g., core deposits, embedded customer relationships)
- Effects on management behavior in running the business
 - How does front-ending of income affect business practices?
 - Shorter-term focus?



Fair Value Accounting Project to Issue Supervisory Guidance

- Intended to promote sound risk management practices by financial institutions on the use of fair value accounting
 - Governance
 - Policies and Procedures
 - Valuation Methodologies and Models
 - Internal Controls
 - Use of Outside Parties
 - Internal Audit Function
 - Supervisory considerations



FRB Staff Study on Commercial Loan Fair Value Practices

- Initiated due to the trend toward fair value accounting and the significance of loan activity for banking organizations
- Conducted to obtain additional insight on industry use and practice of fair value accounting for loans, including methodologies, modeling, and control frameworks
- Consisted of discussions with several large and internationally active banks and, for comparison purposes, a few large and internationally active U.S. securities firms



FRB Staff Study on Commercial Loan Fair Value Practices

- Fair value measurement and modeling
 - Most loan facilities do not have secondary market prices and fair values must be estimated
 - Reliability appears strongest for fair value of an investment-grade level obligor based on its CDS spread, but less so for a non-investment grade obligor when using generic curves
- Common valuation framework using a “waterfall” approach based on a hierarchy of market price sources
 - Secondary loan market price
 - Obligor credit default swap curve (most prevalent)
 - Obligor bond credit curve
 - Generic credit curve; firm equity value



FVO Adoption by Banking Organizations

- Early adoption by more than 150 banks
 - Some rescinded early adoption decision and/or restated previously issued earnings
- Application to repos and reverse repos, securities, interest-bearing deposits, structured debt, loans held for sale, equity-method investments, MSR's, hybrid financial instruments



FVO Adoption by Banking Organizations

- Consider carefully the implications before utilizing the fair value option
 - Understand the “Three Vs”
 - Valuation
 - Verification
 - Volatility
 - Strong risk management
 - SR 07-11, The Fair Value Option and the Applicability of the Market Risk Capital Rule



Valuation During Market Stress

- CAQ white paper provides helpful guidance
 - Measurements of Fair Value in Illiquid (or Less Liquid) Markets (e.g., FAS 157)
 - Look to market transaction prices for fair value
 - Significant decline in transaction volume doesn't necessarily = inactive market or distressed sale



International Accounting and Reporting



IFRS to U.S. GAAP Reconciliation

- SEC ruling that eliminates requirement for foreign registrants using IFRS to reconcile their year-end financial statements to U.S. GAAP
- Banking regulators are considering the use of IFRS for regulatory reporting for foreign banking organizations
 - A limited number of Fed reports already permit IFRS
 - However, many reports (e.g., FR Y-9, bank Call Report, FFIEC 002) require U.S. GAAP
- SEC Concept Release regarding U.S. registrants and IFRS



**IFRS to U.S. GAAP Reconciliation
Key Differences for Banking Organizations**

- Business combination accounting (e.g., contingent consideration, goodwill, minority interest)
- Sales/Financing
- Netting of derivatives
- Revaluation reserves for non-financial assets
- Allowance for loan losses
- Hedge accounting
- Loan origination costs

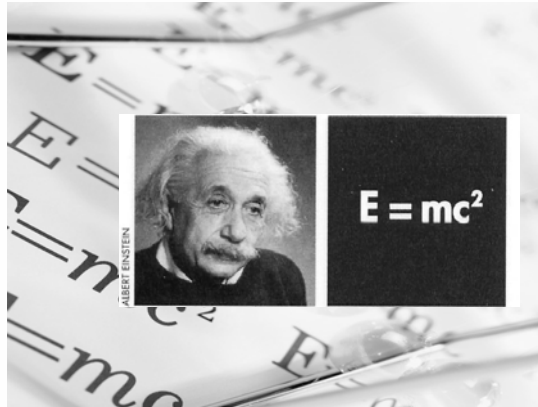


**Basel Committee on Banking Supervision
Accounting Task Force Update**

- Accounting Issues
 - Conceptual Framework
 - Financial Instruments
 - Valuation/Modeling of Fair Value
- Audit Issues
 - Global Audit Quality
 - IAASB's Clarity Project on International Standards on Auditing
- Industry Dialogue



Basel II



Basel II—What It Is

- U.S. final rule modernizes the risk-based capital rules for large, internationally active banks
 - U.S. rule is based on the advanced approaches in the Basel II international accord
- Advanced approaches use bank internal estimates of risk to determine risk-based capital requirements for credit and operational risk (Pillar 1)
 - Separate credit risk approaches for wholesale, retail, securitization, and equity exposures
 - Bank-specific advanced measurement approaches for operational risk
- Enhanced supervisory oversight (Pillar 2)
- Enhanced public disclosure (Pillar 3)



Basel II—Where We Are

- Final rule applies to large, internationally active banks; other banks may choose to apply the final rule if they meet the qualification requirements
- Banks may begin parallel run as early as January 2008



Basel II—Significant Developments

- Final rule conforms more closely to the Basel II international accord than did the September 2006 proposed rule
- Agencies intend to issue a standardized approach proposal in the first quarter of 2008

