

FASB MARK-TO-MARKET ACCOUNTING CHANGES

Material or Misunderstood?

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Many market commentators think that mark-to-market accounting is the root cause of the collapse of the U.S. financial system. They believe that the Financial Accounting Standards Board (FASB) Statement No. 157, “*Fair Value Measurements*,” which took effect in the beginning of 2008, exacerbated the problems of our financial system, and that if mark-to-market accounting were simply repealed the majority of these problems would disappear. Furthermore, they note that FASB Chairman Bob Herz’s testimony on mark-to-market accounting in front of Congress on 12 March 2009, and FASB’s initial proposals on this issue on 16 March 2009 are nearly coincident with the stock market bottom on 9 March 2009, which has been followed by a strong rally in financial stocks; their assumption is that the mark-to-market accounting rule changes are one of the primary reasons for the stock market rally. At Lazard Asset Management, we disagree with these points of view. Are the FASB mark-to-market accounting changes material? Probably not. Are they misunderstood? Most definitely, yes.

HISTORICAL TIMELINE OF MARK-TO-MARKET ACCOUNTING CHANGES

In September of 2006, FASB finalized its "FAS 157 Fair Value Measurements" accounting standard, which became effective for financial statements issued in the first quarter of 2008. After some major market events in 2008, the SEC was prompted by the U.S. Congress to assess mark-to-market accounting standards. Subsequently, FASB proposed and released new mark-to-market accounting rules.

S&P 500 Index*



* Source: Standard & Poor's. As of 28 May 2009

** FASB Staff Position

This paper is organized in four sections, where we will:

1. Define fair value accounting, or what is commonly referred to as mark-to-market accounting
2. Illustrate the impact of the FASB mark-to-market accounting changes on the financial statements of financial institutions
3. Discuss if and how these proposals change Lazard's outlook on financials
4. Review Lazard's involvement with the FASB organization during the proposal process

1) Fair value, or Mark-to-market, Accounting

Mark-to-market accounting values the assets and liabilities of a company based on current market prices. At the other end of the accounting spectrum is historical cost accounting, where all assets and liabilities are recorded at their original cost or amortized cost basis.

Opponents of this rule note that, in periods of market distress, mark-to-market accounting overstates the losses of financial institutions, because the losses implied by distressed market prices often exceed the actual losses experienced over time. Given that financial institutions utilize leverage (in some cases 10x to 30x leverage), relatively small declines in asset prices can wipe out the equity base of a financial institution. Merrill Lynch, Bear Stearns, Lehman Brothers, and Countrywide provide clear evidence of this fact.

Strict adherence to mark-to-market accounting probably overstates the losses on securities in severe market downturns. However, we do not believe that mark-to-market accounting was the primary cause of the collapse of our financial system. Rather, we think that investors, financial institutions, and some members of Congress have generally used mark-to-market accounting as a convenient scapegoat for the bad financial and regulatory decisions made over the past decade. We also believe that the three final FASB Staff Positions (FSPs) issued on 9 April 2009 are much closer to the original mark-to-market FASB Statement 157 than the FSPs issued in their 16 March 2009 proposals.

2) Impacts of the FASB Accounting Changes on the Financial Statements of Financial Institutions

FASB finalized three major changes on 9 April 2009:

- a) Definition of distressed transactions (FAS 157-4)
- b) Revised accounting for other-than-temporary impairments (OTTI) for securities in financial statements (FAS 115-2 and FAS 124-2)
- c) New disclosure requirements (FAS 107-1 and APB 28-1)

We will analyze each of them in more detail.

a) Definition of distressed transactions

The “*Proposed FSP FAS 157-e, Determining Whether a Market Is Not Active and A Transaction Is Not Distressed*,” issued on 2 April 2009, fell short of original market expectations that financial institutions would probably mark up their asset values based on the initial March 16 proposals. The April 2 proposal was a swing in the pendulum back in the direction of mark-to-market accounting and away from the mark-to-model accounting tilt ascribed to the March 16 proposals.

The FASB staff document notes:

“Many constituents were confused by the example included in the proposed March 16 FSP and questioned whether the Board is changing the objective of a fair value measurement in an inactive market.”

“The staff recommends that the Board emphasize the FSP does not change the objective of fair value measurement. Even when there has been a significant decrease in market activity for the asset, the fair value objective remains the same. Fair value is the price that would be received to sell the asset in an orderly transaction (not a forced liquidation or distressed sale).”

“The staff recommendation is to remove the presumption that all transactions are distressed unless proven otherwise.”

“The staff recommends the Board require entities consider whether there are circumstances that indicate a transaction is not orderly. They could include:

- *Seller is in or near bankruptcy or receivership or the seller was required to sell to meet regulatory requirements.*
- *There was a usual and customary marketing period, but the seller marketed the asset to a single market participant.*
- *The transaction price is an outlier relative to other similar transactions.”*

The objective of this FSP is to assign a fair value to a security in an orderly market. This allows companies to mark-to-model securities only if they can demonstrate that the security trades in a disorderly market.

On 9 April 2009, FASB issued FAS 157-4 “*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly.*” This FAS provides additional guidance for estimating fair value in accordance with the original FAS 157, *Fair Value Measurements*. Fair value is the price that would be received when selling an asset in an orderly market transaction.

This FSP provides for two new disclosure requirements:

- 1) To disclose in interim and annual periods the inputs and valuation techniques used to measure fair value, and to discuss any changes in valuation techniques and related inputs during the period
- 2) To define major equity and debt security types. Major security types would include: equities, U.S. government debt, corporate debt, MBS, CMBS, CDO, and other debt obligations

b) Revised accounting for other-than-temporary impairments (OTTI) for securities in financial statements

The “*Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-Than-Temporary Impairments,*” issued on April 2, will change how companies account for OTTI for securities holdings on the income statement and the balance sheet. If a company intends to hold the security and does not anticipate the recovery of the entire cost basis of it, then an OTTI has occurred. In this case, the company must write down the investment to fair value and record the impairment in two places (see Exhibit 2 for a flow chart describing the methodology and Exhibit 3 for an example):

- Any credit losses are reflected in the income statement
- Any non-credit losses (illiquidity component) are reflected in the accumulated other comprehensive income (AOCI) section of shareholders equity on the balance sheet

In the example in Exhibit 1, the company lowered its mark-to-model Level 3 value for its MBS securities portfolio during the quarter, and it claimed this was due entirely to a non-credit loss (illiquidity); therefore the loss did not hit the income statement.

EXHIBIT 1: FAIR VALUE MEASUREMENTS USING SIGNIFICANT UNOBSERVABLE INPUTS (LEVEL 3)

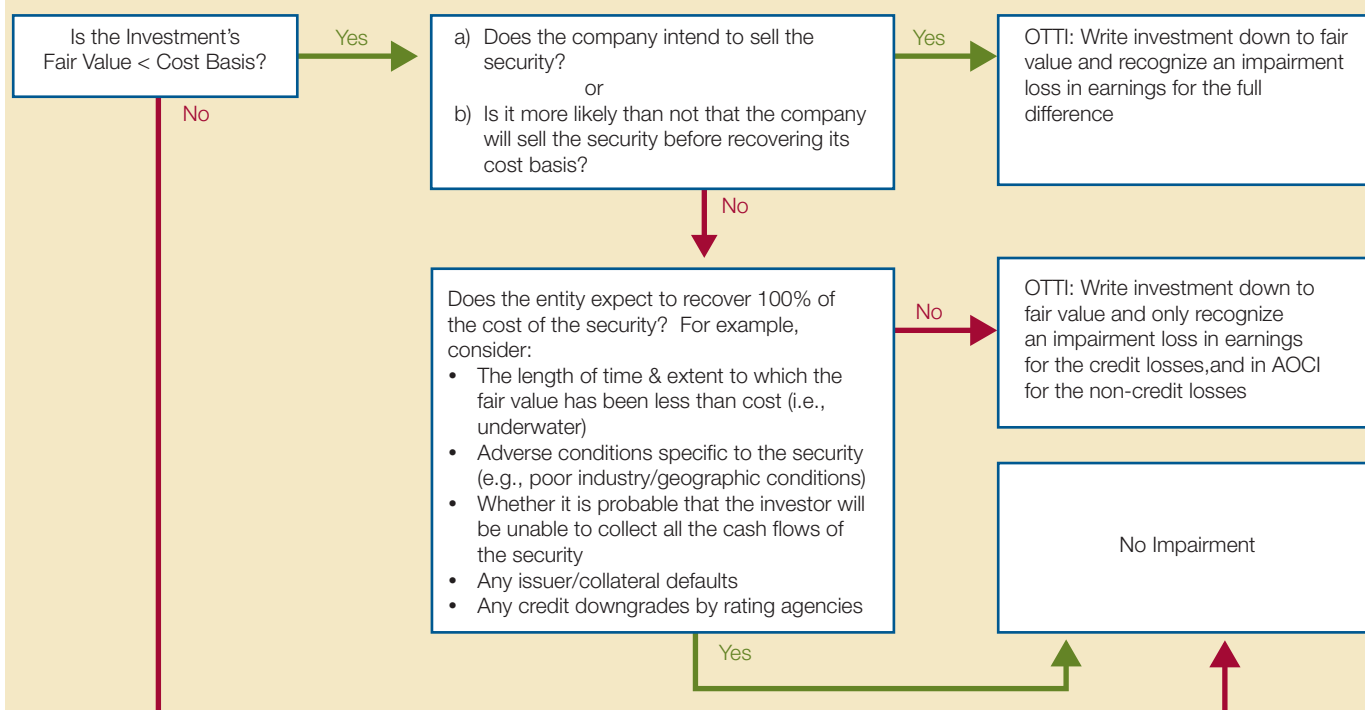
(in U.S. \$)	MBS	Derivatives	Total
Beginning Balance	80	14	94
Gains/Losses			
Included in earnings		11	11
Included in other comprehensive income	(5)	4	(1)
Purchases, issuances, and settlements		(7)	(7)
Transfers in and/or out of Level 3		(2)	(2)
Ending Balance	75	20	95
Source: FASB Shown for illustrative purposes only.			

This is the most controversial new accounting change, and, in fact, two of the five FASB board members dissented on this FSP.

The obvious question to ask is how will management determine how much of an impairment loss to include as a credit loss (income statement impact) versus a non-credit loss (AOCI balance sheet impact)? Thus far, FASB has provided no guidance on this issue, so it will fall entirely to managements’ discretion. We believe that managements may attempt to place more of the OTTI in the non-credit loss category because this will lead to better earnings and improved regulatory capital ratios. In fact, regulators typically do not include unrealized losses run through AOCI in the balance sheet when considering capital levels under regulatory definitions. Not surprisingly, most of the financial institutions that decided to adopt this rule in the first quarter of 2009 placed the majority of the OTTI losses in the non-credit loss category.

Note, however, that the determination of credit versus non-credit losses has no impact on tangible common equity for financial institutions, as long as the ultimate price of the asset is the same. To be clear, the biggest potential impact of these changes in accounting standards is that a company will determine if the market prices of their assets are not reflective of normal activity (i.e., are distressed); if that is the case, the company could then legitimately value these assets using its own mark-to-model (Level 3) valuation at a level above the market price. In this situation, tangible common equity is indeed positively impacted. Conversely, if the model leads to a value that is the same as the market price, there is no impact on tangible common equity.

EXHIBIT 2: FASB'S NEW OTTI RULES FOR AVAILABLE-FOR-SALE AND HELD-TO-MATURITY DEBT SECURITIES



Source: FASB, Credit Suisse Accounting & Tax Research
Shown for illustrative purposes only.

EXHIBIT 3: EXAMPLE OF AN APPLICATION OF THE NEW OTTI RULES

(in U.S. \$)	Current Rules		Proposed Rules		
	(A)	(B)	(C)	(D)	(D)
End of quarter	No OTTI Charge	OTTI Charge	No OTTI Charge	OTTI Charge Scenario 1	OTTI Charge Scenario 2
Assets	600	600	600	600	600
Liabilities	500	500	500	500	500
Common Stock	500	500	500	500	500
Retained Earnings	-	-400	-	-400	-100
AOCI	-400	-	-400	-	-300
Total Equity	100	100	100	100	100
Earnings:					
OTTI charge	-	400	-	400	400
Less:					
Non-credit losses*	-	-	-	-	-300
OTTI Impact on Earnings	-	400	-	400	100

Scenario 1: More likely than not the security will be sold before recovery of its cost basis.

Scenario 2: Not more likely than not the security will be sold before recovery of its cost basis, but there has been a \$100 credit impairment on the security.

*Non-credit losses on securities more likely than not to be held until recovery — recorded in AOCI.

Source: ISI Accounting & Tax Research
Shown for illustrative purposes only.

We believe that the breakout between credit and non-credit losses is a great academic exercise, and we are sure many accounting professors will debate it in the future. Importantly, the OTTI number tells us how much management believes the company's assets are worth and, even more importantly, what assumptions (which are included in the disclosures) they use to calculate asset values.

As stated earlier, two FASB members dissented on the OTTI proposals. We report below two direct quotes from the FASB document explaining why:

- “First, they believe that an OTTI should be measured as the entire difference between the fair value and the carrying value of the impaired item with that change fully reflected in net income as an unrealized loss. This FSP serves to increase the unrealized losses reported in other comprehensive income, exacerbating investors’ concerns with Tier One Capital formation.
- Second, they recognize that a likely result of this change is a reduction in the amount of impairment losses recognized in net income. They are concerned that to the extent the proposed FSP results in delayed recognition of impairment losses in net income, there also may be a negative effect on investor confidence.”

The objective of the FSPs No. FAS 115-2 and FAS 124-2, issued on 9 April 2009, “*Recognition and Presentation of Other-Than-Temporary Impairments*” is to improve the OTTI accounting guidance. This FSP states that the difference between the present value of the cash flows expected to be collected and the amortized cost basis is the credit loss.

According to the FASB organization, this FSP:

- has little or no effect on total tangible common equity, and
- does change the net interest margin to better reflect the cash flows expected to be collected by an entity.

c) New disclosure requirements

The FSP No. FAS 107-1 and APB 28-1 “*Interim Disclosures about Fair Value of Financial Instruments*” requires disclosures about fair value of financial instruments for quarterly interim reporting periods as well as annual financial statements.

We provided the FASB with a list of disclosures essential for us and other analysts to properly value and understand the financial statements of a financial institution. Although FASB’s disclosure requirements do not match what we had hoped for, they are an improvement compared to present disclosures. It will be interesting to see how much additional disclosure financial institutions will provide.

3) Do these proposals change Lazard’s outlook on financials?

At Lazard, we analyze each financial institution individually with a focus on balance sheet strength, organic cash flow, and operational flexibility within a scenario analysis framework. The change in accounting rules has not impacted any of these key metrics, but has impacted the scenarios we use. To be more specific, previously the bear case scenario contemplated, in many cases, the risk of a forced capital raise due to losses on illiquid (distressed) securities that are directly impacted by the mark-to-market accounting changes. Under the new accounting rules, we have adjusted our bear case scenarios for a number of financial institutions to reflect the decreased probability of a forced capital raise.

One question we will only be able to answer over time is how the companies will spin their reported financials:

- Will they emphasize the income statement, asserting it better reflects actual expected cash flows than the balance sheet?
- Will stronger companies emphasize the balance sheet and try to distance themselves from weaker peers, thus effectively weakening even further their competitors by introducing doubts around capital adequacy?

In conclusion, the balance sheet may end up being a more conservative document than the income statement. Additionally, both statements may be slightly less conservative than before. Some market transactions, which were previously used in the fair valuation process, may no longer be considered relevant given the relaxation of the definition of distressed transactions and may thus be replaced with Level 3 mark-to-model valuations.

4) Lazard’s Involvement with the FASB During the Mark-to-market Proposals Process

The authors of this paper participated in discussions with three of the five FASB board members on these proposals over a period of two weeks in late March 2009.

On 26 March 2009 we had an hour-long conversation with two FASB board members, as part of their investor outreach initiative. We provided them with our interpretation of the March 16 proposals and what changes or additions we would make as users of the financial statements. The FASB organization spoke with 20 money management companies about these proposals and with a total of 40 outside organizations, including rating agencies. We also forwarded to FASB an extensive list of disclosures we believe are key to restoring investors’ trust in the financial statements of financial institutions.

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