

# Bank Asset/Liability Management

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## Hocus Pocus...Exit Price

### **Key Considerations for Determining New Fair Value Disclosures**

Exit Price, two simple words added by the Financial Accounting Standards Board (FASB) to fair value disclosure requirements, appear to have magically transformed something deemed previously worthless (FAS 107/ASC-825) into something that is now presumably of great value. For those institutions subject to fair value reporting, most will be required to exercise their wizardry skills in conjunction with March 31, 2018 quarterly financial reporting.

In January of 2016, the FASB issued Accounting Standards Update 2016-01 (Subtopic 825-10): *Recognition and Measurement of Financial Assets and Financial Liabilities*. The primary purpose of this new guidance, effective for fiscal years beginning after December 15, 2017 and related interim periods, is to require public entities to use the *exit price* notion when measuring the fair value of financial instruments for disclosure purposes.

The term *exit price* has raised a lot of questions and confusion within the community banking industry. This article addresses the more pertinent issues that banks should understand about the nuances of valuation in general, and exit pricing in particular.

### **The Art of Valuation**

Valuation is a practice that is part math and part art. After selecting a methodology to apply to a particular problem, math is pretty much *black and white*. Art, on the other hand, is quite subjective in nature, and sometimes the beauty or purpose of a piece of art is completely lost on the observer without a clear understanding of what the artist intended.

Recognizing there are varying shades of gray in many items subject to public disclosure, one has to be thoughtful in how this blend of math and art in the form of fair value exit pricing disclosure is presented and framed.

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Not all assets or liabilities are equal when it comes to the ease of valuation. FASB acknowledged this and defined a preferred hierarchy of valuation approaches (Level 1, 2 and 3) that was driven by how liquid and observable a market there is for any given financial instrument. With each level, the assumptions used to derive a fair value become more subjective. Level 3 valuations are much more dependent upon bank-specific assumptions. Interestingly, the updated guidance *reduces* the amount of disclosure required around the valuation of Level 3 instruments. Some would argue that not knowing the more critical assumptions would render the resulting information less useful.

The biggest area of concern, confusion and likely inconsistency will reside in fair value estimates for the loan portfolio. Let's begin with a simple question in order to provide some important context.

*Q: How much does it actually cost to value a portfolio of loans?*

A: Portfolio-specific valuation methodologies and costs can vary greatly based on a variety of variables; however, they are consistent in that they *are not cheap*. In the world of mergers & acquisitions, loan valuations can cost into the six figure range to estimate initial carrying values and the related impact on loan yields and goodwill determination. The point is that valuations required to support carrying values and accounting adjustments come at a significant cost, and thus the notion of reasonableness would imply that such detailed valuations are beyond the intended scope of the fair value footnote disclosure exercise.

Notwithstanding, a bank is still left with the prospect of estimating values for its specific loan portfolio, but now with the added constraint of an *exit price* which is clearly in the eyes of the beholder. And those eyes belong to the accountants opining on your bank's financials. Based upon a number of discussions with some major firms, there is a clear change in attitude regarding the attention previously paid to prior fair value footnote disclosures vs. the likely focus under the new exit pricing guidance. **Poof! Magic!**

Not really. It appears there might be a greater interest in *covering their asset* valuation reviews in much greater detail given concerns that somebody looking for trouble might point out that reported *exit price* value disclosures were not *confirmed* by a subsequent transaction, e.g. bulk loan sale, securitization, bank acquisition. Hm... Hm... Hm...

Let's examine two common loan types, residential mortgages, one of the most liquid types of loans, and commercial real estate (less liquid).

- *Residential Mortgages* — Residential mortgages have a fairly liquid market. The availability of a broad reference

market in terms of actively traded mortgage-backed securities provides additional data that can be useful in estimating loan values, adjusting discount rates for Agency guarantee and servicing costs. Some have utilized secondary loan markets for establishing a reasonable and reliable baseline for estimating whole loan values.

That said, a common practice has been for banks to utilize their current origination rates as a market value discount rate in estimating fair value disclosures. The logic being that their current rates reflect the vagaries of their markets in terms of liquidity, credit, and other related costs, and that their loan and lease losses (ALLL) inherently captures current potential credit adjustments.

For banks with meaningful balances in non-conforming loans, current origination rates provide a frame of reference for quantifying adjustments to the discount rate (regardless of how determined) to account for factors associated with particular loan types that move them further and further out of the conforming loan market.

As you can see, inconsistency abounds.

- *Commercial Real Estate (CRE)* — The secondary market for CRE is dominated by pools of loans with deal sizes that do not reflect most markets serviced by community banks. Further, the collateral included in a loan pool securities wrapper is often mixed and credit enhanced through various subordination and tranching methods. This makes determining the underlying price of a part of the pool extraordinarily difficult to ascertain.

Because of this, it has been a common approach to use recent origination rates for different segments of the loan portfolio as a starting point for valuations. A pricing spread is derived by subtracting a comparable interest rate from a benchmark such as the FHLB or LIBOR curve from the rate earned on a loan. Regardless of the approach, it is important that loan age and seasoning for all loan types be captured within the valuation model.

There are rational checks and balances that have made a *new origination rate approach* reasonable with regard to previous valuations for financial statement disclosure purposes.

This leads us to the advent of the term *Exit Price*, which adds an additional layer of assumptions that make comparability increasingly nebulous.

### Exit Pricing

Loans held by community banks generally have a limited, if any, observable secondary market. Pricing on the sale of portfolio slices is not usually disclosed as public

information, and whole bank acquisition marks are murky because of aggregation in publicly reported figures. True pricing levels are usually only available to brokers who generally guard pricing information closely, and any marks comparable to a particular bank's portfolio would require significant and costly due diligence to support.

For this reason, all loan values by definition will be reflective of what management feels is a reasonable estimate of what another party might pay in an orderly transaction. This begs the question as to *who* is that party, because every buyer does not look through the same lens.

There are a few additional factors that come into play with estimating *exit price* that impact the discount rate utilized for valuation. Liquidity premiums and credit risk are two of the most prominent required adjustments.

- **Liquidity Premiums:** Since selling a package of loans likely requires due diligence, broker fees, and other potential costs, it is important to account for a liquidity premium when assessing the *exit price* of a loan portfolio. For some loans with credit characteristics that are easily understood, such as 30 year residential mortgages, this premium may be low relative to, for example, a cash flow dependent C&I loan. It is possible, yet often impractical, to estimate these premiums through informal surveys of brokers and observations of securities with similar collateral.

So, assuming a liquidity premium of 25bp for a particular loan type, this could be added to the discount spread rate associated with new origination volume. Liquidity premiums will differ by asset class/loan type, and it is unlikely that thousands of institutions will be able to get *liquidity marks* by calling *the street* every quarter.

- **Credit Adjustment:** Buyers adjust their offer price based on what they perceive to be a reasonable allowance for credit losses. It appears that the majority of banks assume that the ALLL captures this element of exit pricing, noting that the allowance calculation and assumptions are heavily reviewed by internal and external sources for reasonableness. In other words, ALLL has an implied reasonable credit adjustment that a market participant would consider.
- **Bank-Specific Adjustment:** Banks will have unique and significant factors that make pricing certain loan pools more difficult. An example might be when most residential mortgages are non-conforming for various reasons,

consist of mobile homes, for example, and are originated at higher rates than conforming product. There are numerous potential differentiating variables in the commercial and agricultural sectors. *Selling* such assets will likely have a higher associated liquidity premium. In these cases, the bank will likely elect to gross up the new origination spread and/or the liquidity premium on this loan class to get to what they feel is a reasonable price estimate.

The key will be to identify some sound logic for explaining the bank's estimated adjustment. We believe the accountants do understand the challenges here, and will be looking for a *good story*.

- **Severely Impaired Loans:** For loans that are in non-accrual status, the bank is required to write down the asset to the lower of cost or market through the provision or specific reserves. As this process is heavily reviewed by internal and external resources, the current carry value under the new guidance will likely be considered an appropriate reflection of its fair value.

### Some Concluding Thoughts

The devil is always in the details. It has been both surprising and candidly frustrating to see the lack of consistency and direction emanating from the accounting profession in terms of its expectations for *how* exit prices should be ascertained for footnote disclosures — particularly as related to loans. It has been like *pulling teeth* to get any kind of reasonably detailed, let alone consistent, input from a range of accounting professionals. Most industry articles and white papers have been filled more with hyperbole and generalities than with helpful implementation guidance.

It appears that *adequacy* of disclosures, and inherently the exit value methodologies and assumptions, will be ascertained *in the field*, with some element of best practices emerging over time. That means that the old saying of "*what is good for the goose may not be good for the gander*" is likely to ring true.

Accordingly, the best advice we can give to all of you who will be required to present fair value disclosures is to sit down and have candid explicit discussions with your accounting firm. It's hard enough being an effective banker these days, let alone a magician.

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